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Money after Meech

by

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Quebec's Interest in Remaining Part of the Canadian Monetary System Is Strong, but Not Absolute

As it moves toward greater political and cultural independence, Quebec nevertheless has a strong economic interest in remaining part of the Canadian monetary system and in maintaining common Canadian markets in goods, services and labor. Such arrangements require political supervision; given the regional diversity of so-called English Canada, this is most likely to be provided by a Canadian federal government in which Quebec is represented.

Such an outcome cannot, however, be taken for granted. The attractions of continued Canadian monetary union could be destroyed by a failure of the Bank of Canada to deliver and maintain monetary stability and — a more remote possibility — by an upsurge of western separatism seeking monetary autonomy for that region. Most important of all, however, a separate currency pegged to the U.S. dollar would be a viable second-best option for Quebec, should the forces that defeated the Meech Lake Accord try to extract an unacceptably high political price from Quebec in return for the benefits of maintaining current economic ties.

Introduction

In the aftermath of the failure of the Meech Lake Accord, and as part of a move toward greater political autonomy, should, or will, Quebec create its own currency?

This *Commentary* argues, in turn: that the prospect of the dissolution of the Canadian monetary system might disturb international capital markets; that Quebec nevertheless has a strong interest in maintaining the current monetary system; that this interest involves the maintenance of other economic ties, too; and that these economic ties argue for the continued existence of a Canadian federal government in which Quebec is represented.

There are, however, threats to this optimistic scenario. The politics of anti-inflation policy need to be handled with care. Western separatism — associated with populist views about the proper conduct of monetary policy — could conceivably become strong enough to endanger the cohesiveness of the Canadian monetary union from another direction. On the other hand, inability on the part of the Bank of Canada to withstand political opposition to its price stability goal might, in the long run, make continued participation in the Canadian monetary system unattractive to a responsible Quebec government.

Moreover, the supporters of a centralized form of federalism, having defeated Meech Lake, might again miscalculate. If they try to use Quebec's interest in close economic ties with the rest of Canada to extract other concessions, they might force it to sacrifice economic self-interest to political principle. Though continued participation in the Canadian monetary system is Quebec's best option, a separate currency — pegged to the U.S. dollar — may well be a viable alternative.

What Financial Markets Care About

Constitutional Discord

One of the more interesting nonevents of the past few months was the foreign-exchange crisis that did not occur on June 25. Even so, there was widespread dumping of Canadian bonds in May. Foreign holders disposed of a record $2.2 billion of them in that month. Furthermore, Canadian-U.S. yield spreads remain high. It is hard to believe that all this does not have something to do with Canada's constitutional problems. The fact that nothing happened in the markets on June 25 means only that the failure of the Meech Lake Accord on June 23 had already been discounted in advance, not that it was irrelevant.

Foreign creditors and investors do not care about: whether or not Canada has a Senate, let alone how many members it has and how they are appointed; what language is used in outdoor advertising in which cities, and who does or should have jurisdiction over such matters; the balance between federal and provincial governments in the design of new social programs; and so on. How many Canadian investors could answer a simple quiz about how Swiss, Germans, Belgians, Brazilians, or Argentines manage such affairs? Far fewer than would volunteer a well-informed opinion about the relative prospects for earning a decent and secure return on investments in those countries.

And that is the point: as long as constitutional instability does not threaten to generate economic instability, Canadians can wallow in it to their heart's content without directly doing the country any great economic harm. How much indirect damage is done — by diverting political energy away from seeking solutions to certain long-standing structural economic problems — is, of course, quite another matter, though beyond the scope of this *Commentary*.

The solutions Canadians eventually find to the political and cultural aspects of their constitutional difficulties will be important. But if those solutions do not affect confidence in Canada's capacity and willingness to service its present debts, and any that it might incur in future, the rest of the world will let us get on with it.

Political Sovereignty and National Monies

International capital markets take notice when words such as "sovereignty" or "nationhood" turn up in Canadian constitutional debates. Whatever they may mean in Canadian political discourse, in the rest of the world these words carry with them the distinct suggestion that parts of what is now the Canadian monetary system might begin to issue their own separate currencies.

It is a fact of western history that a separate national currency is one of the defining features of the sovereign nation state. Moreover, for the past 50 years, it has been taken for granted that monetary policy — exercised through control over that national currency — is one of the prime instruments through which the government of a sovereign nation state fulfills its obligations to its citizens.

The prospect that Quebec might introduce a separate currency — apparently implicit in the prediction that it will move toward "sovereignty" — unnerves international capital markets. What proportion, if any, of Canadian dollar debt might be redenominated? Would the new currency be responsibly managed? Might market inefficiencies associated with the breakup of the Canadian monetary union adversely affect the long-run profitability of investment here? Such uncertainties damage Canada's current status in those markets.

A Separate Quebec Dollar?

What a "Separate Quebec Dollar" Might Mean

In the jargon of the textbooks, money is a means of exchange, a unit of account, and a store of value; but it is the two first roles that are paramount. In this country, Canadians receive incomes, pay bills, and buy goods with Canadian dollars. Canadians also draw up contracts, calculate tax liabilities, and keep books in Canadian dollars.[1]

For Quebecers to have a separate money would involve their using a Quebec dollar for these purposes instead of the Canadian variety. But for the establishment of a Quebec dollar to have more than a purely symbolic meaning, there would have to be more to it than that. It would have to be possible, or at least conceivable, that its value could vary against the Canadian dollar.

Without this condition, a Quebec dollar would simply be a Canadian dollar by another name — and a nuisance, too. Quebecers would have to change currency when they travelled to the rest of Canada, as would other Canadians when they travelled to Quebec. Any business that traded across the Quebec-Canada border would have extra book-keeping costs, and so would banks and other financial institutions doing business in both currencies.

The Relevant Choice for Quebec

Had history been different, Quebec might now exist as a separate country, and would surely have its own currency. It generates about the same gross domestic product as does Finland, a little less than Austria, and a little more than Denmark or Norway, and all of these countries have their own currencies. None of those currencies, however, is freely floating.[2] This suggests strongly that, even if it already had a distinct currency, Quebec might not choose a flexible exchange-rate regime.

That, however, is not the primary issue. Quebec currently shares a currency with the rest of Canada. The choice that it now faces is not the traditional one between a pegged and a flexible exchange rate. It is more complex. It must decide between maintaining a common currency and creating a new one whose exchange rate might then be permitted to float freely.

In a recent *Commentary* on Canada's exchange-rate regime, Bill Robson and I argued for the virtues of maintaining a floating rate between the Canadian and U.S. dollars rather than moving to an adjustable peg arrangement.[3] In Quebec's case, it is possible, but not

certain, that a floating rate might be preferable to a pegged arrangement for a separate dollar if that currency already existed. It might nevertheless also be the case that the nuisance costs of having a separate currency, and the difficulties of establishing its viability, are too large to justify creating it in the first place.

One set of reasons for this can be summed up in two words: size and openness. The nuisance costs of maintaining a separate currency increase as the economy becomes more open and its size decreases. At the same time, the benefits that arise from an independently managed currency and, hence, a flexible exchange rate diminish as the economy's openness increases and its size decreases.

Exchange-Rate Flexibility and Real Shocks

A flexible exchange rate for a separate currency helps an economy to adjust more easily to "real" shocks to the conditions of supply and demand for its products in world markets than it would under a common currency arrangement. When, to take one example, demand falls off for a particular export, the real wages — that is to say, wages measured in terms of the goods and services they can buy — of those engaged in its production must fall; as a second-round effect, they must fall elsewhere in the economy, too, as labor leaves the contracting industry and has to be absorbed elsewhere.

It is generally believed that money-wage cuts can be difficult to negotiate. It is difficult to reduce *real* wages, therefore, by trying to force *money* wages down. In contrast to money wages, a flexible exchange rate can move easily. A fall in the exchange rate increases the price of imports and, therefore, the domestic price level. It moves real wages down by an alternative and less direct route. Adjustment to a fall in export demand, then, tends to be smoother under a flexible exchange rate than under a fixed rate or common currency.

Size and Openness

The benefit here is not available in equal measure to any economy. The flexible exchange rate has its useful effects by stealth, and it becomes more difficult to keep the relevant mechanism hidden — and hence effective — as the economy becomes smaller and more open.

This advantage is nevertheless important in the case of Canada's floating dollar.[4] Quebec is smaller and more open than Canada, however, and the smaller and more open an economy, the more aware of the likely effects of shocks to sectors engaged in trade, and the more prepared to respond to them, are its workers going to be.

Under a common currency, the smaller and more open the economy, the readier will workers be to renegotiate money wages in the face of a foreign shock to a particular sector. Under a separate currency with a flexible exchange rate, they will also be better able to see through — and, hence, in their money wage bargaining respond to — the effects of exchange-rate changes on prices and real incomes. As difficulties in changing money wages in the face of real shocks to the tradables sector of the economy decrease and as the responsiveness of money wages to exchange rate changes increases, however, the less important become the advantages of a flexible exchange rate in smoothing the economy's adjustment to such shocks.

It is also worth noting that the more diversified an economy, the less impact on its overall performance does a shock to any particular sector have in any case. Though Quebec is less diversified than Canada, it nevertheless produces a wider variety of traded goods than many economies of its size.

How small, open, and diversified does an economy have to be before this advantage of exchange rate flexibility ceases to be of decisive importance? Quebec is small, open, and diversified enough for the choice to be at least problematic. That is the conclusion implied by

comparison with the small European economies mentioned earlier.[5]

Monetary Independence and the Inflation Rate

A flexible exchange rate confers upon an economy the ability to choose its own inflation rate, regardless of its size, openness, or diversity. In the days when it was believed that unemployment could be lowered permanently by raising the inflation rate, this seemed an important advantage. No serious economist nowadays believes in such a permanent tradeoff, however, so this element in the once-traditional case for maintaining exchange-rate flexibility is no longer respectable.[6]

Even though they are fallacious, arguments about how Quebec could use monetary independence, coupled with a flexible exchange rate, to promote low unemployment and rapid growth will no doubt be heard in debates about its future. But the fact remains that these are bad arguments for monetary independence, not good ones, and will be unlikely to find an audience among Quebec's political leaders.

The ability to choose its own inflation rate may nevertheless be beneficial to a small economy if the partner whose currency it might share is itself prone to run an undesirably inflationary policy. An economically responsible government of a more independent Quebec would find attractive the continued use of the money of a Canada whose central bank had credible anti-inflation credentials, but it would shy away from continuing to use a currency that threatened to become unstable.

Here, we have an important and underdiscussed reason why the Bank of Canada's ongoing pursuit of price stability deserves support. Its achievement and maintenance will make continued membership in the Canadian monetary union more attractive to Quebec. The fact that the Bank's policies are politically unpopular at the moment — in Quebec as elsewhere — because of the short-run costs they impose, should not be allowed to obscure this longer-run benefit.

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Problems of Establishing a New National Money

Monetary independence for Quebec would involve the creation of a new currency. A new currency, however, cannot simply be launched and guaranteed a successful existence by government fiat. People have to be persuaded to use it for transactions, to denominate their debts in it, and so on. If they are to do this voluntarily, they must be convinced of the currency's viability and stability.

The government of a more independent Quebec could decree that a new Quebec dollar alone be used to pay taxes and that only contracts denominated in it be enforceable in law. It could even forbid the holding and use of other currencies by its citizens.[7] Such steps would certainly promote its domestic use.

It would be a different matter with international transactions. Foreign businesses dealing with Quebec — including those located in what remained of the Canadian monetary sys-

tem — would be free to decide on the currency they used, and foreign investors to would be free to decide on the currency in which debts were denominated. They would be bound to prefer to deal in familiar, already existing currencies than in a new, untried one.

Anyone in a position to choose whether or not to deal in freely floating Quebec dollars would be bound to ask why the currency had been established and might well conclude that there were no obvious good economic reasons for doing so. The suspicion that there might be some less obvious, and perhaps bad, reason underlying its creation would inevitably arise and make the currency unpopular.

Recall that the existence of a separate currency enables a country to opt for a flexible exchange rate and, hence, to choose its own inflation rate. We all know from bitter experience that a government which chooses a high rate of inflation can gain by buying goods and services from the private sector with constantly depreciating money. We also know that it can gain by allowing inflation to erode already existing domestically denominated debt and to increase the yield of progressive taxes whose thresholds are not fully indexed.

This widely available knowledge would make potential outside investors nervous that the government of Quebec had established its own currency to exploit these possibilities; and even if those suspicions were groundless, the burden would be on Quebec to prove this before its currency became viable.

Quebec could try to "borrow" viability by establishing its new dollar on a fixed exchange rate with the Canadian dollar. But this would not solve the problem — why bother to set up a new currency at all under such circumstances? Quebec would pay all the nuisance costs of monetary independence but reap none of the economic benefits. The suspicion would inevitably exist that the measure had been taken to open up the possibility of changing the exchange rate in the future, and why do that if not to keep open the inflation option?

To use an exchange rate initially fixed on the Canadian dollar to establish the credibility of a new currency would not achieve that goal. It would merely shift fears about its stability into the future, not eliminate them. Whether such fears were well grounded would not be relevant. Their mere existence would make the viability of a new Quebec dollar questionable. These arguments would be much less relevant, however, if the Quebec dollar sought credibility from a peg on the U.S. dollar — an option that is discussed below.

Some Implications of Continued Canadian Monetary Union

Oversight of the Monetary System

All in all, then, it is hard to believe that, as it readjusts its relations with the rest of Canada, Quebec will initially seek anything other than a continuation of present monetary arrangements. But this has implications for other economic and political ties.

First, there is the matter of political control of the financial system. Though the Bank of Canada now has considerable short-run autonomy, responsibility for the broad thrust of monetary policy rests with the federal Minister of Finance, who, in turn, is answerable to the federal Parliament for the manner in which he exercises that responsibility.

Furthermore, it is uncontroversial that the concentration of the Canadian financial system — along with the existence of widespread branching of financial institutions across the country — does much to promote capital mobility within Canada and gives the system considerable stability. These advantages are well worth preserving, but they require the continued existence of some system-wide and politically responsible regulatory authority.

Mobility of Labor and Goods

Second, the maintenance of a common currency would keep the burden of adjustment to real shocks to the Quebec economy that originate elsewhere in Canada concentrated where it is now —namely, on the local labor market.

Box 1

The Irish-British Monetary Union

In monetary arrangements, there seem to be exceptions to every rule. Though it is surely realistic to expect Quebec — as a member of a Canadian monetary union — to wish to participate in the political control of monetary policy, it is worth noting that 20th-century history provides at least one example of such a union in which the junior partner had no political influence over policy, and accepted this state of affairs for a significant period of time.

When it achieved independence from the United Kingdom in 1921, the Irish Free State — later, the Republic of Ireland — continued to use British money for a further seven years. In 1928, it began to issue its own currency, but nevertheless remained in effect part of the U.K. monetary system by rigidly maintaining the value of the Irish pound at parity with the pound sterling. This arrangement lasted until 1979. Irish citizens also retained free access to the U.K. labor market, and migration remained an important adjustment mechanism for the Irish economy.

The moral here is that monetary union and a common labor market do not necessarily imply the continuation of a political union of some sort. This particular arrangement worked for as long as it did, one suspects, for three main reasons. First, in the 1920s, a more or less automatic gold standard was still regarded as the normal peacetime exchange-rate regime. Second, as already noted, Ireland neither sought nor received any political say in the conduct of British monetary policy — something that it is hard indeed to envisage Quebec accepting *vis-à-vis* the rest of Canada.

Third, the senior party in the monetary union was a highly centralized, unitary state in which regional pressures on the monetary authorities were essentially nonexistent. Monetary policy, then, was not a matter of continuous political contention, as it is in Canada.

It is worth noting that, in addition to wage variations, in- and out-migration is a labor-market-adjustment mechanism.

To the extent that labor can move out of Quebec when demand for its exports in the rest of Canada falls, and into Quebec when that demand rises, less reliance has to be put on wage adjustments to cope with shocks.[8] A common labor market, then, is a useful supplement to a currency union; and these go naturally together with a common market in goods and services, too. But if Canada-wide labor and goods mobility is to be maintained, some Canada-wide authority will have to exist to guarantee that mobility.

Labor mobility, in particular, will be enhanced if that same authority has powers to ensure the portability across political boundaries of eligibility for social programs; and it will be further enhanced if the social programs in question do not differ too radically among jurisdictions.

The political authority to be charged with such tasks is beginning to sound suspiciously like a federal government, and Quebec, as part of the currency union, would want to be represented in it. (See, however, Box 1, containing a brief discussion of the precedent of the Republic of Ireland, which maintained a currency union with Britain from 1921 to 1979 without maintaining any sort of political union.)

What Kind of Federal Government?

One suggestion currently being discussed is that some sort of "superauthority" — in which the two governments of Quebec and "English Canada" are represented — might supervise such matters of joint interest as monetary policy. This plan presupposes that "English Canada" is as unified a political entity as Quebec, and that is farfetched.

It is an important and long-standing feature of Canadian economic history that monetary policy is regionally divisive. In the West and Atlantic Canada alike, recent inflation was widely perceived as a central Canadian problem, and the high interest rates that accompa-

nied the Bank of Canada's efforts to contain it were frequently denounced as inappropriate to economic conditions in those regions.

But regional divisions about monetary policy have existed for much longer than the past two or three years. They are deeply entrenched, and "English Canada" would be quite incapable of speaking with one voice on how to run the policy of a Canadian monetary union. It would, therefore, be unwilling to enter into any arrangement that required it to do so. Is it conceivable, for example, that any western province would accede to arrangements that gave Quebec a potentially decisive voice in the design of monetary policy?

Any political body charged, among its other duties, with overseeing the operations of a Canadian monetary union would have to be capable of mediating among many competing regional interests, not simply between the interests of Quebec and those of some nonexistent homogeneous entity called "English Canada". It would have to be the government of a — perhaps radically redesigned and less centralized — Confederation of which Quebec was one important member.

If the foregoing prognosis is accurate, and if the economic reasons for maintaining a common Canadian currency for common Canadian labour and goods markets prevail, then the basic preconditions for renegotiating virtually every other aspect of Confederation without the constant threat of a foreign-exchange crisis hanging over the proceedings will be met. Certain possibilities could, however, upset matters.

Possible Dangers

Monetary Independence for the Western Provinces

The western provinces frequently have felt that Canadian monetary policy has worked against their interests. Whether this view is right or wrong is irrelevant. What matters is that it is widely held. Certainly, the western provinces are relatively undiversified resource- and agriculture-based economies, heavily dependent on markets outside Canada. They are often subject to large swings in their terms of trade, with respect to central Canada as well as the rest of the world. A respectable economic argument can therefore be made that they might gain more from establishing their own currency and permitting it to float against the Canadian dollar than would Quebec.[9]

The political forces in the West that might campaign for greater political independence include those with populist roots, but western populism — in both Canada and the United States — has traditionally been marked by a strong streak of inflationist monetary thinking.[10] The best-known manifestation of this was the popularity of the "Social Credit" ideas of Major C.H. Douglas between the wars. But the tradition is both older than that movement and, more important, has outlasted it. Its echoes are heard even now, particularly on the prairies, in grass-roots calls for low interest rates.

Western populists would find particularly attractive the scope that their own currency would provide to indulge in inflationary low-interest-rate and low-exchange-rate policies. The probability of their attaining sufficient support to follow through on this track is surely small: to begin with, not everyone who would make the case for a separate western currency is a populist. As Confederation is restructured, however, it would be worthwhile for all concerned to beware of provoking a populist backlash in the West.

It is easy to conceive of western provinces asking that any political concessions granted to Quebec also be made to them. It is not impossible to conceive of their seeking monetary independence — regardless of whether Quebec asks for it or not — if they begin to feel that their interests are not taken seriously in central Canada, nor is it impossible to conceive of a separate western currency falling prey to populist inflationary policies. That prospect could be a source of instability for the Canadian dollar on world markets, and it is desirable that it remain a remote one.

Other Pressures on Quebec

If we assume, as I think we should, that Quebec's political leaders genuinely care about monetary stability for the province, it follows that a reversion by the Bank of Canada to inflationary policies could persuade them, after all, to opt for their own currency as a defense against inflation. Thus, current pressures on the Bank to abandon its price-stability goal present not just an economic threat, but could be politically divisive, too.

It has been taken for granted in this *Commentary* that the defeat of the Meech Lake Accord will have a decentralizing effect on Confederation. The forces that defeated the agreement, however, did so because it was already too decentralizing for their tastes. There is a danger that those same forces will be tempted to use Quebec's strong self-interest in maintaining close economic ties with the rest of Canada as a lever to try to force it to accept their own version of federalism.

It is difficult to predict the outcome of such a scenario. There must surely be a danger, however, that Quebec could be pushed into sacrificing economic self-interest to political principle and to opt for looser economic ties, including monetary ones, than material considerations alone would make desirable.

A Pegged Rate on the U.S. Dollar: A Viable Option for Quebec

A Quebec that moved in such a direction might not be as materially well off as it could be, but it would surely be economically viable. As I have already noted, a number of prosperous economies of about Quebec's size maintain their own currencies. Moreover, if Quebec was successful in maintaining more or less intact the trading links with the United States that currently exist under the Canada-U.S. Free Trade Agreement, the question of its monetary relations with the United States would arise.

Quebec trades heavily with the United States, and a number of its industries — pulp and paper products, for example — have a strong interest in exchange-rate stability *vis-à-vis* the U.S. economy. Moreover, Quebec has in the past — and, no doubt, will in future — borrow heavily in U.S. dollars. Depreciation of a new Quebec dollar against the U.S. dollar, therefore, would increase Quebec's burden of foreign indebtedness.

Any Quebec government that, for political reasons, cut its monetary ties to Canada would, as argued above, find its currency an object of suspicion in international markets. This fact in itself would increase Quebec's foreign debt burden, not least because it presumably would accept liability for a share of current federal debt as well.

Such a cost of monetary independence would be unavoidable, but it could at least be minimized if, once markets had set a value for the new Quebec dollar, the relevant authorities pegged it to its U.S. counterpart and treated the maintenance of that peg as a serious policy priority.

The incentive to maintain the peg would be clearly visible to participants in international capital markets, it would lend credibility to the exchange rate and, hence, it would help to establish the long-run viability of a new Quebec currency. A more complex variation on this theme — with a Quebec dollar pegged to a basket of currencies in which the U.S. dollar was strongly represented — would also be viable and credible. There are, as we have seen, several precedents for such an arrangement among smaller European economies.

In short, a decision by Quebec to introduce its own currency because membership in a Canadian monetary union became politically intolerable would be economically costly, but a freely floating currency would not be its only — nor, perhaps, even its best — alternative. A Quebec currency, pegged to the U.S. dollar — or, perhaps, to a basket of currencies — could well become credible and viable. Anyone concerned about the continued existence of Canadian Confederation should bear that in mind.

Concluding Comments

It seems to be understood where it matters most — namely, in Quebec — that Quebec's

Box 2

Quebec Views on Monetary Union

Robert Bourassa's commitment to a position against a separate Quebec currency is not new. In a 1980 contribution to the debate on sovereignty association, he argued forcefully for the benefits of Quebec's remaining part of the Canadian monetary system. He also argued that a decision to do so implied a continued commitment to political federalism as well. The title of his essay, *L'Union monétaire et l'union politique sont indissociables* (Monetary and Political Union Are Inseparable) succinctly conveys its theme.

In many respects, his argument was similar to that set out in this *Commentary*, differing mainly in that it dwelled at some length on the political implications of the use of monetary policy to affect levels of income and employment. Unlike Bourassa in 1980, I do not see any role for monetary policy here.

Though Bourassa's 1980 views on the desirability of maintaining Canadian federalism are hardly those of the Parti Québécois, it is nevertheless worth noting that an April 27 speech given by PQ leader Jacques Parizeau at Johns Hopkins University shows him to favor, though not strongly, the maintenance of a common currency for Canada and Quebec.

Moreover, two research reports prepared by expert economists for the Quebec Ministry of Intergovernmental Affairs in 1978 — one on theoretical issues and the other dealing with case histories — both concluded that it would be desirable for Quebec to remain within the Canadian monetary system even as it moved to a political relationship of sovereignty association (see Bernard Fortin, "Les advantages et les coûts des différents options monétaires d'une petite économie ouverte: un cadre analytique"; and Henri-Paul Rousseau, "Unions monétaires et monnaies nationales: une étude économique de quelques cas historiques").

In a slightly later paper, Rousseau argued that it was possible and desirable for Quebec to move toward greater political independence while maintaining monetary union with Canada — the maintenance of a monetary union giving political recognition to the continued existence of strong and desirable economic interdependence. He also broached in that paper the possibility of some kind of pegged exchange-rate regime — perhaps on the U.S. dollar — as preferable to a free float should Quebec establish its own currency (see Henri-Paul Rousseau, "L'intégration politique: est-elle nécessaire à l'intégration monétaire?" in Claude Montmarquette et al., *Économie du Québec et choix politiques* (Montréal: Les Presses de l'Université du Québec, 1979).

remaining within the Canadian monetary system is highly desirable. Premier Robert Bourassa's June 24 announcement that his government would avoid any actions likely to lead to economic instability sounded very much like an assurance that the separate currency trapping of political sovereignty was not on his immediate agenda, and he confirmed this explicitly before the Quebec National Assembly on September 4. (See Box 2, where other discussions among Quebecers on the issue of monetary union are outlined.)

That being the case, Canada should, over the next few years, be able to get on with changing its constitutional arrangements without an impending foreign-exchange crisis being an ever present feature of the political landscape. Or at least it should be able to do so if Canadian politicians are sparing in the use of the rhetoric of "sovereignty" and if markets come to appreciate that — in this case — the word does not, in any event, carry with it all of its traditional connotations.

The economic arguments for the maintenance of a Canadian economic and monetary union overseen by a Canadian federal government are strong, but political problems could lead to their defeat. Insensitivity to western populism could turn it into western separatism. Though this particular threat is a remote one, it is not unrelated to another — namely, that political forces hostile to the Bank of Canada's monetary policies could undermine the stability of the Canadian dollar, and so reduce Quebec's interest in maintaining its membership in the Canadian monetary union.

Canada's politicians will need to execute a careful balancing act here, as they defend the Bank while keeping western separatism in check.

They will also have to be careful not to misjudge the extent to which Quebec can be bullied into accepting federalism of the pre-Meech Lake variety. The promises that Premier Bourassa made on June 24 — alluded to above — were hardly unconditional, and Quebec may well have a viable monetary option — in the shape of a Quebec dollar pegged to the U.S. dollar or to a currency basket — to fall back on. On the Quebec side, the diversity of interests that exist outside the province and make some kind of bilateral Quebec-rest-of-Canada constitutional arrangement impossible will also have to be appreciated.

In summary, economics can help us understand some of the complexities of Canada's constitutional impasse, but it will take a good deal more than economics to cope with them.

Notes

1 Unusually, Canadians also carry out a certain amount of internal exchange using a foreign currency — namely, the U.S. dollar.

2 Denmark is a formal member of the European monetary system, and Austria acts informally to maintain a stable exchange rate with the currencies of the system. Finland and Norway both peg their rates to baskets of the currencies that are most important to their foreign trade.

3 See David E.W. Laidler and William B.P. Robson, *The Fix Is Out: A Defense of the Floating Canadian Dollar*, C.D. Howe Institute Commentary 18 (Toronto: C.D. Howe Institute, 1990). We took it for granted throughout that *Commentary* that the formation of a U.S.-Canada monetary union was not a viable political option. Its arguments and conclusions are not, therefore, directly applicable to the Quebec-Canada case.

4 See ibid., pp. 6–7.

5 Nevertheless, economies smaller than Quebec find a flexible exchange rate desirable. New Zealand, an economy of less than half the size is a case in point. It is, however, a less diversified economy. Also, and crucially, New Zealand has recently undergone a radical deregulation of financial and goods markets, while — for the time being, at least — leaving in place some extremely inflexible labor-market institutions. These facts, which make a flexible exchange rate particularly desirable, have no parallels in the case of Quebec.

6 For a clear account of why the inflation-unemployment tradeoff is, at most, a short-run phenomenon, see Douglas D. Purvis, "The Bank of Canada and the Pursuit of Price Stability," in Richard G. Lipsey, ed., *Zero Inflation: The Goal of Price Stability*, Policy Study 8 (Toronto: C.D. Howe Institute, 1990), pp. 29–66.

7 Such prohibitions would involve a whole paraphernalia of exchange controls that would inhibit the movement of goods and capital across Quebec's borders. An outward-looking, market-oriented Quebec government would hardly be willing to resort to them.

8 This is not to ignore the fact that language presents something of a barrier to labor mobility between Quebec and "English Canada". However, the existence of this barrier does not argue for the erection of others.

9 Of course, "the West" is not a homogeneous economy. British Columbia, with its important trade links to Asia, is more vulnerable to swings in exchange rates other than that linking the U.S. and Canadian dollars. Manitoba, with its industrial sector around Winnipeg, is more diversified than either Alberta or Saskatchewan. Though British Columbia, on balance, would probably fit into a western currency area, Manitoba might be better off maintaining monetary links with central Canada.

10 In the United States, the presidential campaigns of 1892 and 1896 were marked by inflationary proposals for the free coinage of silver. More generally, the natural concern of agriculture — with its heavy commitment to investment in land — for the maintenance of low interest rates and of resource extraction for the maintenance of low exchange rates seems to many to pit the interests of the West against those of central Canada, where manufacturing and financial industries are concentrated. Though I do not support this interpretation of clashing interests, it is widely held and therefore a fact of Canadian political life that must be taken account of in debates about monetary policy.

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